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TAGS: ECON EFIN ENRG EINV PGOV MX
SUBJECT: ECONOMIC CONDITIONS IN MEXICO

¶1. (SBU) Summary: Although the global financial crisis has weakened MexicoQs economy, most analysts do not fear a repeat of the 1995 peso collapse. Financial conditions in Mexico Q most notably the absence of a large foreign debt Q have improved measurably over the financial situation existing in the early 1990s. However, the Mexican economy will not likely grow in 2009 and recovery in 2010 will not reduce MexicoQs 40 percent poverty rate. With virtually no success in meeting key campaign promises of reducing poverty and creating employment, the ruling PAN party faces serious political challenges in the 2009 congressional and gubernatorial elections. Furthermore, a deepening economic recession and costs associated with MexicoQs war on organized crime/narco-trafficking could potentially spawn populist candidates vying for the 2012 presidential election. However, with four years to go in the Calderon Administration, it is too early to place any political bets. End Summary.

CURRENT ECONOMIC STABILITY

¶2. (SBU) Mexico strengthened financial institutions and economic and monetary policies following the peso collapse of the mid-nineties, making the economy less susceptible to a similar crisis now:
-Foreign debt has been significantly reduced to around 4% of GDP;
-A floating exchange rate has played a significant role as an adjustment variable;
-U.S. dollar reserves surpass 80 billion;
-Inflation remains in check -- although inflation has risen from 3.8% in 2007 to 6.23% in November 2008, it is far from the two-digit inflation a decade ago --;
-The government has made an effort to diversify exports through new trade agreements --still 80% of MexicoQs exports go to the U.S.--;
-Mexico has no sub-prime mortgage problem;
-Mexico continues to promote massive infrastructure programs to expand the economy despite recent tightening of credit and reduced foreign direct investment (down from USD 27 billion in 2007 to an expected USD 17-18 billion in 2008).

¶3. (SBU) Due in part to the strength of Mexican financial institutions, the Calderon government continues to tout the long-term stability of the Mexican economy. Since the 1995 crisis, the government has undertaken a series of bold financial reforms to strengthen its financial system in accordance with international standards, such as the improvement of banking accounting standards,

disclosure of information, capitalization requirements, credit and risk assessment and qualifications, promotion of private credit bureaus, and granting of licenses to retailers to operate banks. In a recent report, Merrill Lynch rated Mexico as the second least vulnerable country out of 44 nations surveyed based on its solid economy. The Finance Secretariat is working on legislation to simplify existing bankruptcy procedures and a bill to allow the operation of correspondent banks is pending in Congress. After two previous administrations mired in political impasse, Calderon managed to achieve a consensus with opposition parties for the passage of pension, fiscal and energy reforms, which although limited in scope were positive steps in the right direction to relieve some pressure on public finances.

ECONOMIC TROUBLE LOOMS

¶4. (SBU) Despite improvements since the 90Qs crisis, Mexico faces numerous serious challenges. Oil production has decreased more rapidly than anticipated while global oil prices have fallen dramatically. Mexico depends on oil revenue to fund nearly 40 percent of itsQ national budget and a dramatic drop in oil income could severely impact the entire spectrum of Mexican social development programs. Although the government wisely hedged oil sales at about USD 70 per barrel for 75 percent of its 2009 exports, declining production will mean far less income from oil exports. Many experts question whether new oil drilling at Chincotepec can compensate for the depletion of MexicoQs existing wells. Mexico does not have a robust tax collection system to counter the oil revenue loss and reform of the tax system appears unattractive as Mexico seeks to bolster waning foreign investment through tax incentives. Mexico has also failed to prevent tax evasion and has done little to

simplify the existing procedures to spur tax collection.

¶5. (SBU) Mexico maintains its position as the worldQs 11th largest economy and one of the top ten automobile producers. Two-way trade with the United States registers one billion U.S. dollars every day. However, manufacturing continues to record negative growth and the automobile industry has sharply reduced production. President CalderonQs pledge to create about a million jobs in 2008 will more closely approach the 300,000 mark. Credit card defaults, the potential economic burden caused by out of work illegal immigrants returning to Mexico, company failures resulting from risky derivative ventures, and the cascading effect of lower oil production and prices all will take a toll on a struggling emerging economy. A ten percent decline in remittances during November perhaps foreshadows a significant decline in the 25 billion dollars sent home annually by workers in the U.S.

¶6. (SBU) Most significantly, the Mexican government must divert social development funds to combat spiraling organized crime and narco-trafficking spreading throughout the country. While the USD 400 million Merida Plan (plus additional funds proposed for next year) should help considerably, Mexico will likely endure a protracted fight against the cartels with detrimental effects on foreign investment, tourism and internal stability. Without a formal strategy that reduces the countryQs heavy reliance on oil revenues, security costs will bleed the Mexican treasury for many years to come. To reduce poverty, the Mexican economy must achieve 6-8 percent annual growth. Projections for 2009 indicate zero percent economic growth.

WHAT CAN BE DONE

¶7. (SBU) President Calderon succeeded in reforming Q marginally the energy sector to make way for increased foreign participation in developing oil resources. However, most observers believe that the reforms are not adequate to turn around declining production. Deeper reforms coupled with urgent attention to development of alternative renewable energy sources are needed.

¶8. (SBU) Further investment in ports, roads, and other infrastructure would make Mexico more competitive with China and other Asian nations in accessing the U.S. market. But, with tight international credit, many of CalderonQs ambitious construction

plans have been delayed and will unlikely yield much benefit prior to the end of the Calderon administration. Given that the lack of liquidity will likely delay larger infrastructure projects, the administration switched its strategy to focus on smaller projects, such as the maintenance of roads, schools, and water treatment plants.

¶9. (SBU) The Calderon government remains committed to free trade and open markets. Recent tariff reductions confirm the governmentQs intention to pursue greater competitiveness. Calderon has expressed concern that a potential review of NAFTA might nurture uncertainty in an area Q trade - where the economy has shown substantial progress. Calderon will likely seek further harmonization of free trade agreements in Latin America and elsewhere and he will argue for greater access to the U.S. market Q more border crossings and more Mexican trucks on U.S. highways.

¶10. (SBU) The government needs to tackle public and private monopolies to increase competition mainly in the telecommunications, financial and energy sectors. Only with lower operational and security costs, will Mexico be able to increase foreign investment and develop its domestic industry. Regardless of the final results of the 2009 mid-term elections, the government and the Congress should make a pledge to pass further reforms, such as the labor and telecommunications reforms to improve the countryQs competitiveness. The fundamental question is whether the prominent families who control MexicoQs wealth will be willing to open the economy to greater transparency and competitiveness.

¶11. (SBU) Further support is required for the sustainable development of micro, small and medium-sized businesses (SME), which provide employment to 72% of the population and which contribute to

52% of the countryQs GDP. SMEs need more access to financing, not only from development and commercial banks, but also from a more democratic stock market. The government should continue to pursue the reduction of existing red tape and burdensome procedures to open new businesses throughout the country, and reduce the existing informal economy. As a result of lower oil revenues, the federal government will eventually have to cut funds transferred to local governments. Thus, states and municipalities should work on developing their own sources of income and gain more access to capital markets through more securitizations in order to invest in infrastructure.

COMMENT: WHERE MEXICO IS HEADED

¶12. (SBU) We believe that a repeat of the 1995 peso collapse appears unlikely. Still, the Mexican economy will likely suffer a continued sharp downturn in 2009 and the government will not make much progress on the key economic issue facing the country: poverty and social inequities. As long as 40 percent of its people live in poverty, Mexicans will remain susceptible to the lure of illegal migration, vulnerable to trafficking in people, arms, and drugs, and potentially open to the demagogic appeals of populist political candidates. Having failed to deliver as the education or employment president, Calderon and his PAN party face a hard challenge in 2009 congressional and gubernatorial races. Deteriorating security conditions throughout the country will further erode the electoral chances of moderate leaders in Mexico and could eventually open the door to less democratic challengers. This does not mean, however, that there is a Chavez currently waiting in the wings. To the contrary, the more radical elements of the PRD Party who refuse to accept CalderonQs presidency and who took over the congress have alienated a significant portion of MexicoQs citizens and undermined that partyQs stability. The more immediate threat to political stability comes from narco-traffickers and other organized crime elements who challenge security and cause the government to divert precious resources to fight rampant crime throughout the country.

GARZA